Best Practices of USAID's Development Credit Authority

Prepared by
USAID
Office of Development Credit
Washington, DC

August 2002

A message from the Director...

USAID's Development Credit Authority (DCA) was created in 1998 to mobilize local private capital through the establishment of real risk sharing relationships with private financial institutions in USAID countries. The tool is available to all USAID overseas missions and provides a vehicle for providing much needed credit to an array of enterprises and underserved sectors.

DCA is already active with credit guarantee agreements in many USAID countries. This publication provides six examples of successful programs. They touch on a variety of sectors and geographic locations, but all focus on channeling aid to those who lack access to financial services. It is hoped that by examining the challenges and successes in implementing these guarantees, other Missions may be able to apply this knowledge to future DCA projects.

The following case studies highlight recent DCA activity:

Guatemala: Loan Portfolio Guarantee for Bancafé to increase its microlending business.

Mexico: Loan Portfolio Guarantee for FinComún to provide microfinancing to poor communities in Mexico City.

South Africa: Loan Guarantee for the Greater Johannesburg Municipal Council to finance long term infrastructure needs.

Philippines: Bond Portfolio Guarantee to the Local Government Unit Guarantee Corporation to foster the growth of a municipal bond market.

Bulgaria: Loan Portfolio Guarantee to the United Bulgarian Bank to demonstrate the financial viability of long term project financing for energy efficiency investments.

Mexico: Loan Guarantee for Unión Progreso to expand rural and agriculture microenterprie development activities in the northern state of Chihuahua.

The Office of Development Credit is available to support DCA project development, working with USAID overseas missions, local financial institutions, and potential borrowers. Please contact us if you would like to learn more about DCA.

John Wasielewski
Director, Office of Development Credit

Loan Portfolio Guarantee for Financial Institution in Guatemala

Bancafé

Guaranteed Party: Bancafé

Recovering from decades of civil conflict, the Peace Zone is a rural region in Guatemala with the greatest concentration of poverty. The hardest hit are women and indigenous groups, who suffer from low incomes and pervasive malnutrition. Most Guatemalan banks do not operate in this area, making it difficult for microentrepreneurs and small farmers to secure long term credit.

USAID has extended a Loan Portfolio Guarantee to Bancafé, a Guatemalan bank that wants to grow its microlending business. The original DCA agreement contained specific regional lending targets to ensure that lending was concentrated in the Peace Zone. This agreement has since been amended to relax the geographic restrictions, as they proved to be too ambitious.

To extend its reach into rural areas, Bancafé has chosen to wholesale part of its lending activity through a Private Voluntary Organization with a successful track record managing microfinance programs.

Qualified lender	Bancafé
Qualified borrowers	Microenterprises, small businesses, municipalities, non-governmental organizations, and cooperatives.
Qualified projects	Public and private investment projects
Geographic scope	Initially the Peace Zone. Subsequently amended to include all areas outside the Dept. of Guatemala
Type of guarantee	Loan Portfolio Guarantee
Max. portfolio amount	$5.0 million (Guatemalan Quetzal equivalent)
DCA guarantee	50% of principal only
Guarantee ceiling	$2.5 million (Guatemalan Quetzal equivalent)
Term of guarantee	5 years to place loans under coverage (2000-2005)10 years to submit claims to USAID (2000-2010)
Other covenants	Total loans to single borrower not to exceed $1 million Loan terms not exceed 5 years
Origination fee	0.5% (payable in Guatemalan Quetzal)
Utilization fee	0.5% per annum (payable in Guatemalan Quetzal)

Term Sheet Summary

1. Project Overview

The Loan Portfolio Guarantee supports USAID/Guatemala's Strategic Objective of increasing rural household income and food security, with special emphasis on small farmers and microentrepreneurs. It also supports the

Strategic Objective of improving the management of urban growth in targeted areas, in particular the expanded and equitable delivery of urban services in selected market towns.

Poverty in Guatemala is pervasive and severe; the poor, predominantly women and indigenous populations, suffer from limited education, low incomes, and unreliable food sources. They have limited access to commercial credit and other support services for agricultural production and family-owned businesses. The lack of adequate economic opportunity contributes to widespread malnutrition.

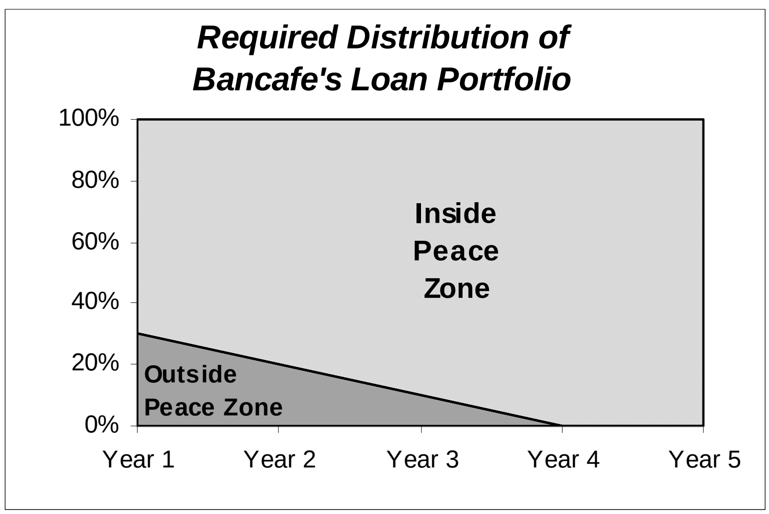
To remedy this situation, private and public sector investments are needed in and around market towns to provide farmers with expanded opportunities for processing and selling their products. Market towns also serve as centers for microenterprise growth.

To promote rural lending, USAID has provided a $5 million Loan Portfolio Guarantee to Bancafé, an established Guatemalan bank with a strong rural presence. The bank has made a strategic decision to grow its microloan business, and the bank president views the Loan Portfolio Guarantee as the right tool to support this new initiative.

2. Economic Analysis

Ninety percent of lending takes place in the Department of Guatemala, where Guatemala City, the most industrial city in Central America, is located. Banks are very traditional and normally make loans based on the amount of collateral offered by the borrower.

The average loan in rural areas is seen by financial institutions as too risky. In addition, most rural loans are too small to be profitable, given the perceived level of risk and the administrative costs to process credit applications. As a result, the Mission has determined that incentives would be needed to increase lending outside of Guatemala City.



One rural area in particular, called the Peace Zone, has suffered greatly from political unrest. The area was defined in the 1996 Peace Agreement which ended 36 years of civil conflict. Financial institutions perceive the Peace Zone as too precarious, and they have avoided establishing branches in the region.

To jump-start badly needed investments in the Peace Zone, specific geographic requirements were incorporated in the DCA agreement (see chart at right):

- No loans in the Department of Guatemala;
- Seventy percent of portfolio in the Peace Zone in year one, increasing to 100 percent in year four.

These geographic lending targets differentiated this DCA guarantee from others. The Mission’s intention was to ensure that portfolio loans would be channeled to the region that most needed the capital and had the fewest resources from the financial community.

By demonstrating the feasibility of small agricultural loans and microlending in the Peace Zone, the DCA facility is intended to help overcome the reluctance of Guatemalan banks to engage in rural lending.

3. Key Partners

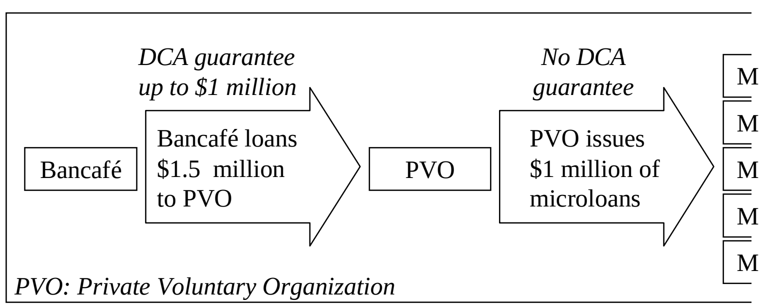
In its search for partners, the Mission spoke to several Guatemalan banks. Bancafé offered the best rural network with 54 branches outside Guatemala City, but even then, its reach into the poorest areas remained limited.

At the time of the DCA agreement, Bancafé did not have a specialized microlending unit, and loans to microenterprises were handled by its consumer bank. To remedy this situation, the bank's management set up a microlending department on par with its other lending groups. USAID provided technical assistance in developing a strategic plan and introducing microloan credit methodologies.

Before the DCA agreement was signed, Bancafé merged with Multibanco, a competitor with a large network of mini-branches. This merger distracted Bancafé's management as it concentrated on restructuring the combined operations. As a result, no loans were submitted by Bancafé in the first year of the DCA facility.

For its microlending strategy to succeed, Bancafé needs to extend its reach in remote rural areas by finding the right distribution channels. One strategy has been to wholesale loan guarantees through Private Voluntary Organizations (PVOs) specializing in microfinance. PVOs are not-for-profit and unregulated microfinance intermediaries that provide credit services to micro and small businesses.

The first wholesale loan submitted for DCA coverage by Bancafé was a $1.5 million loan to Genesis Empresarial, a PVO with branches throughout rural Guatemala. With 27,000 customers (many of them women), Genesis Empresarial has the necessary experience to reach out to microentrepreneurs in rural areas. The DCA guarantee covers the first $1 million of this loan, the maximum allowed in the agreement for a single loan (see chart below).



Structure of Bancafé's First DCA-backed Loan

USAID has also provided technical assistance to the microfinance community and the Vice Ministry of Small and Microenterprises to harmonize PVO financial reporting requirements with those of the banking sector.

4. Financial Analysis

Since this is a Loan Portfolio Guarantee, the borrower risk is difficult to assess. Borrowers in Guatemala may be prone to default or vulnerable to non-payment, especially in the long term. One of the primary determinants of the project's chances of success, therefore, is Bancafé's ability to conduct appropriate credit analyses and to monitor the loan portfolio.

Based on a review of a representative sample of files and documents, Bancafé's credit and collection policies and procedures were deemed to be sound. Cash flow projections provided by Bancafé show that the Internal Rate of Return for the DCA loan portfolio is expected to be 26 percent. An additional risk-mitigating factor is the extensive banking experience of the senior management team.

Given the nature of the proposed loans, the DCA agreement called for an initial review of Bancafé's credit procedures and portfolio composition within the first six months. This review has been delayed as the first loan did not get submitted for coverage until a year into the guarantee.

5. Lessons Learned

The tightly-defined geographic restrictions did not accomplish their intended goal, as Bancafé failed to submit any significant amount of loans from the Peace Zone. The Mission has learned that it is difficult to target lending activity if it does not coincide with the bank's business goals. The Mission has since amended the DCA agreement with less restrictive language that extends coverage to all loans issued outside of the Department of Guatemala.

Bancafé's merger with Multibanco distracted the bank's senior management. The restructuring activities delayed the introduction of any DCA lending activity by a full year. In retrospect, it might have been more prudent to wait until the merger had been fully consummated.

Loan Portfolio Guarantee for Urban Microfinance Institution in Mexico City, Mexico

Fincomún

Guaranteed Party: FinComún

Servicios Financieros Comunitarios (FinComún) is a privately financed credit union founded in 1994. Its principal objective is to provide microfinancing to Mexico City's poor communities that otherwise would not have access to basic banking services.

A consequence of Mexico's past financial crisis is the extreme cautiousness of small depositors, who prefer to invest in sight deposits. One of the purposes of the DCA Loan Portfolio Guarantee is to give FinComún's existing and new depositors the confidence needed to shift to longer term savings products and to attract new deposits.

By extending the maturities of its deposits, FinComún has freed up internal capital to expand its portfolio of microloans. As a result of the DCA facility, FinComún has been able to double the number of monthly loans.

Qualified lender	Fincomún
Qualified borrowers	Microenterprises with no more than 10 employees and assets under $10,000
Qualified projects	Microenterprise investments projected to meet operating and debt service costs
Geographic scope	Mexico City initially, with plans to expand beyond
Type of guarantee	Loan Portfolio Guarantee
Max. portfolio amount	$2.5million (Mexican Peso equivalent)
DCA guarantee	50% of principal only
Guarantee ceiling	$1.25 million (Mexican Peso equivalent)
Term of guarantee	3 years (2001-2003)
Other covenants	Delivery of Operations and Procedures Manual Delivery of business plan with lending targets Single Loans not to exceed $2,500, and total loans to single borrower not to exceed $5,000 Loan terms not exceed 3 year term
Origination fee	1.0% (payable in Mexican Pesos)
Utilization fee	1.0% per annum (payable in Mexican Pesos)

Term Sheet Summary

1. Project Overview

The DCA guarantee supports the Mission's Strategic Objective on microenterprise growth, which is designed to solidify the institutional base for sustainable microenterprise growth. This includes strengthening the management of financial services and promoting mechanisms to meet the needs of microenterprises.

Few commercial banks in Mexico have been willing to provide credit on terms that allow microenterprises to generate sufficient cash to service their loans and earn a profit. Prohibitive procedures and sizeable guarantee requirements effectively discourage microenterprise financing. At the same time, the demand for financial services from under-represented social groups has increased in line with real economic growth in Mexico's urban centers.

Smaller financial institutions such as FinComún offer the best hope of providing new sources of capital for microenterprises. Over half of FinComún's loan recipients are women-based microenterprises involved in a wide-range of commercial activities. These activities include food services, small grocery stores, market vendors, and clothes manufacturing.

Responding to the challenge, FinComún developed a Business Plan for 2000-2005 that called for a substantial expansion of its lending operations and employee training program. Under this plan, FinComún projected to quadruple the number of monthly loans over time. However, its internal analysis showed that it did not have the liquidity to fund its proposed growth beyond early 2001.

By stimulating increased market-based lending by FinComún to microenterprises, the $2.5 million DCA facility is intended to demonstrate the existence of a large, profitable market for these services.

2. Economic Analysis

FinComún is one of the few credit unions to have survived the Mexican financial crisis of 1994-95. The experience of Mexican depositors at that time continues to have an impact on FinComún. Many of its members are reluctant to invest in long term savings products, preferring the flexibility and security of sight deposits.

Before the DCA guarantee was signed, FinComún successfully negotiated a loan from a small Mexican commercial bank. However, this loan is insufficient to fund FinComún's expansion plans. FinComún, therefore, requested a DCA loan guarantee and technical assistance to address structural issues within its investment portfolio. USAID's participation is important to FinComún in several respects, as it:

- Systematizes savings and loans policies and procedures;
- Reaffirms its image as a reliable and reputable financial partner;
- Encourages depositors to invest in longer term savings products;
- Helps FinComún attract new capital through additional deposits.

Without USAID participation, it is unlikely that a market for microlending projects would have developed as rapidly. In the long run, this project will contribute to demonstrate the efficacy of lending to microfinance institutions in urban areas.

3. Key Partners

FinComún was founded in 1994 as a private savings bank with a single office. As the demand for financial services in Mexico City's marginalized neighborhoods increased, FinComún responded to the challenge in two ways:

- *Diversification* with the introduction of microlending in 1997
- *Geographic expansion* with the opening of 18 new branches

FinComún is already planning to expand beyond Mexico City, and it is negotiating with a retail chain to add small banking outlets in its stores.

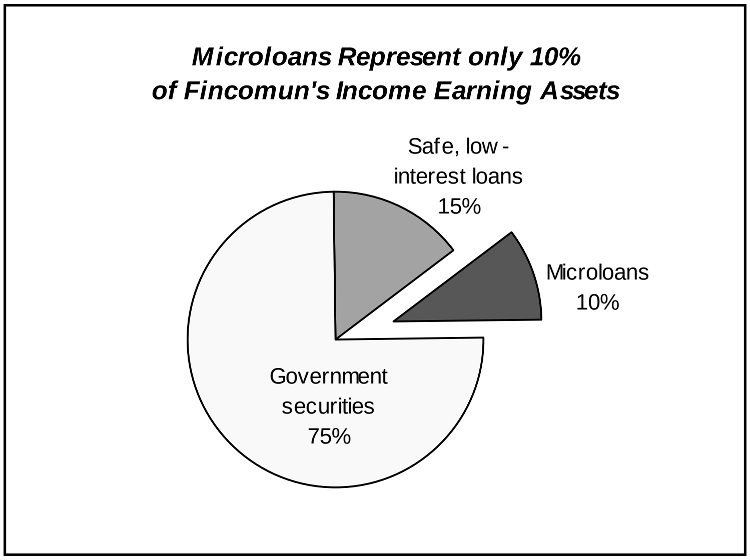
By the end of 2001, the average loan size was $580. Unlike other microfinance institutions throughout the world, FinComún does not offer technical assistance in the form of training or consulting to complement its financial services.

One area of concern for the Mission was the lack of organizational and policy structure in FinComún's operations. USAID offered technical assistance to help the credit union improve its *Credit Operations Manual*, which specifies the full range of the institution's credit policies. Technical assistance was also provided to develop a *Fixed Term Deposits Policy and Procedures Manual*, an *Internal Control Policy Manual*, and an *Internal Audit Organizational Manual*.

FinComún's strength is its use of technology. Loan officers use a customized credit program loaded on Palm PDAs to prepare loan applications at the customer's site. The application is then downloaded at the branch office for processing. PDAs were selected since they were less expensive, at $200 a unit, than laptops.

4. Financial Analysis

Before the DCA facility, FinComún's asset structure was quite conservative despite three years of active lending. Both its assets and liabilities were short-term focused. As a result, too much capital was invested in government securities and safe, low-interest loans. Only 10 percent of FinComún's capital was loaned out to microenterprises (see chart).



FinComún needed to restructure its portfolio to lend more aggressively to microenterprises. But first, the credit union had to convince its cautious depositors to invest with longer maturities.

This step was essential, since longer term savings accounts give financial institutions the ability of undertake new projects using their own capital rather than more expensive outside debt.

The Loan Portfolio Guarantee proposed by USAID has helped resolve this internal problem. By covering at least 25 percent of FinComún's portfolio, the DCA facility has provided the reassurance needed for depositors to authorize their credit union to offer longer-term savings products.

FinComún is a good credit risk for the DCA program. The credit union has minimized delinquency rates (around 2-4 percent in recent years) by closely monitoring loan repayment by its borrowers. Rapid follow-up via an information system means that loan data is shared on a timely basis between credit analysts, branch offices and the home office.

An area of concern has been FinComún's cash flow projections, which appeared overly optimistic based on historical trends. Since 1997, FinComún's operating cash flow has fluctuated widely. One reason has been the rapid increase in salary expenses, which increased overhead costs significantly. FinComún is dealing with this problem by expanding the quantity of loans processed by individual credit officers.

Deposits from members have proven to be less expensive than private bank financing. Today, FinComún is funding its operations at 75 percent of the interbank lending rate, compared to commercial loans that would have cost between 130 percent and 180 percent of that rate.

	Financial Income
–	Operating and Admin. Expenses
=	Operating Cash Flow

5. Lessons Learned

The Mission quickly identified FinComún as a strong candidate for the DCA program. The credit union was one of the few banking institutions in Mexico City to operate on a sound basis after the financial crisis of the mid-1990s. The Mission was also attracted by FinComún's ambitious expansion plans. With its multiplier effect, the DCA guarantee is expected to go a long way in improving the lives of Mexico City's disenfranchised population.

Given the internal situation with its depositors, the Loan Portfolio Guarantee was the right tool for FinComún. As a side benefit to the Mission, the credit facility was easier to negotiate upfront (compared to a Loan Guarantee) since there was no third-party bank involved. However, once the agreement was signed, the Mission had to be prepared for a higher workload reviewing the portfolio of microloans.

Thanks to a new information system, FinComún now prepares a spreadsheet on a weekly basis with a list of microloans for the Mission to review. A smaller mission should determine whether it will have sufficient staff to handle the increased recurring workload of a Loan Portfolio Guarantee.

Loan Portfolio Guarantee for the Municipal Government of Johannesburg, South Africa

GJMC

Guaranteed Party: Greater Johannesburg Municipal Council

Greater Johannesburg represents the largest urban center in South Africa, as well as its financial and commercial hub, contributing 11 percent of South Africa's GDP. Many of the problems common to South Africa's urban areas are magnified in Johannesburg, which has suffered from a declining Central Business District and limited infrastructure investments. Large segments of its population do not receive water, electricity, sanitation, or other urban services.

To remedy this situation, the Greater Johannesburg Municipal Council (GJMC) rationalized its delivery system and created separate utilities to provide city services such as water, electricity, and solid waste. By the late 1990's, GJMC was finding it difficult to negotiate non-securitized long term credit from banks.

With the DCA Loan Guarantee, GJMC was able to secure a 10-year loan to finance long term infrastructure needs. This loan has helped demonstrate the feasibility of municipal lending to an otherwise conservative and risk-averse commercial banking sector. Given Johannesburg's visibility as South Africa's largest city, its success has highlighted the benefits of long term debt financing and has encouraged other local authorities to re-examine municipal debt as an effective funding mechanism.

Qualified lender	ABSA Bank
Qualified borrowers	Greater Johannesburg Municipal Council
Qualified projects	Municipal infrastructure projects
Geographic scope	City of Johannesburg
Type of guarantee	Loan Guarantee
Max. portfolio amount	$25 million (South African Rand equivalent)
DCA guarantee	50% of principal and interest
Guarantee ceiling	$12.5 million (South African Rand equivalent)
Term of guarantee	10 years (1999-2009)
Other covenants	Submission of Project Delivery Plan
Origination fee	0.75% (payable in U.S. dollars)
Utilization fee	0.50% per annum (payable in U.S. dollars)

Term Sheet Summary

1. Project Overview

The DCA Loan Guarantee supports USAID/South Africa's Strategic Objective of increased access to housing and environmentally sound urban services for the historically disadvantaged.

In 1996, white municipalities and black townships were merged into a single municipal entity. Today, Greater Johannesburg employs 1.3 million people (or 10 percent of its active labor force). Because of its preeminence in the economy, Johannesburg's problems loom large in South African society, while its successes serve as a model for other local authorities.

As one of its many challenges, GJMC had to find ways to deliver basic urban services to large segments of its population that had previously received little or no services. The municipal service delivery systems were coming to grips with the challenge of maintaining high service standards in the traditional white areas while increasing the service levels in historically black townships. This impacted GJMC's ability to generate internal resources to fund further infrastructure investments.

As part of a three-year development plan, GJMC created separate utility corporations for the provision of water, electricity, and waste disposal. These utilities are owned by the city, but operate as "for profit" entities. They charge and collect user fees, and they service debt secured from the private sector.

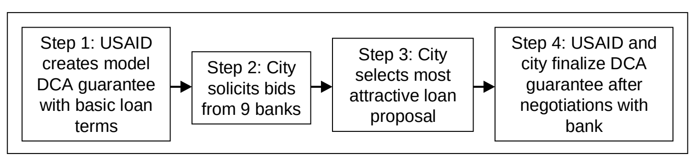
To meet service delivery requirements, these new entities needed major capital investments. To overcome the reluctance of financial institutions to lend to municipalities, GJMC sought a DCA Loan Guarantee from USAID.

Under this $25 million facility, USAID reviewed and approved a Project Delivery Plan prepared by GJMC, rather than approve individual investments. This plan set forth project selection criteria for water and electricity services, roads and storm-water, waste management, housing and urban redevelopment, and health clinics.

2. Economic Analysis

In its search for capital, the city experienced difficulty in raising long term, non-securitized funds for construction and maintenance of its essential infrastructure. There was general recognition that fundamental changes in Johannesburg's governance were going to improve the city's financial situation. Yet more than one domestic financial institution indicated an unwillingness to lend long term to the city without some enhancement.

To help the city raise long term capital, USAID offered GJMC a portable guarantee that it was then able to "shop around" in order to secure the best terms and conditions (see chart). GJMC used outside consultants to prepare a request for proposal that was sent to nine financial institutions. Four bids were received. After a brief review process, ABSA Bank was selected to provide the $25 million loan.



Portable Guarantee Process

Part of GJMC's challenge was its credit rating. South African rating services regularly rate municipalities on the quality of their operations. While the capital market recognized the positive changes that were occurring in the city, the financial institutions were unwilling to lend long term resources to the city.

The DCA facility allowed GJMC to secure a long term loan on credit terms that made it possible for the infrastructure investments to meet operational and debt servicing costs. USAID's participation was essential in helping overcome a reluctance of local financial institutions to invest in Johannesburg's capital investment projects.

3. Key Partners

The Mission took a proactive approach to identifying potential recipients for the DCA facility. It used its extensive contacts within the local government and the private sector to promote the new program.

The timing of the DCA facility was just right. Under new and progressive leadership, Johannesburg's city council was eager to put in place long lasting reforms. A new management team was provided with significant political and financial support to turn the city around. As an example of this new attitude, over half of the service delivery infrastructure was turned over to public corporations or sold off.

In 2000, GJMC formally submitted a Project Delivery Plan to USAID with the following details:

- A list of infrastructure projects covered by the DCA facility;
- GJMC's Capital Investment Plan;
- Public Utilities Reorganization Plan;
- Estimated revenues to service loan debt.

ABSA Bank, one of the big South African financial institutions, moved the most aggressively to work with Johannesburg's city council. It offered the best rates and showed the greatest willingness to think creatively.

4. Financial Analysis

Shortly after the guarantee agreement was signed, Johannesburg received an investment grade rating from an internationally recognized rating agency. The rating report gave high marks to Johannesburg for tackling its major financial problems and related symptoms.

The report noted however that the city's financial viability suffered from improperly managed and inadequate cash flow. The new management is keenly focused on the problem. The Council now has a financial plan, and capital budgeting has been introduced for the first time.

To support its DCA application, GJMC chose three projects to illustrate the viability of its infrastructure investments. Pro forma financial projections showed that all three were expected to be profitable over 10 years.

Type of Project	**Population Served**	**Capital Investment**	**Net Present Value (over 10 Years)**
Sewer for new housing development	100,000	$2.5 million	$1.5 million
Water main replacement	350,000	$1 million	$600,000
Upgrades to electric grid to ensure uninterrupted service	500,000	$1.5 million	$700,000

Pro Forma Financial Projections for DCA Guarantee

Debt service resulting from the $25 million loan amounts to 1.25 percent of the current rates revenue for the Metro. A corresponding increase of 1-2 percent in the overall collection rate, which is a conservative estimate, will therefore easily cover this additional cost. GJMC expects the collection rate to almost double once the infrastructure and services have improved.

5. Lessons Learned

The DCA Loan Guarantee has allowed Johannesburg to raise private capital at market rates to fund infrastructure projects that would not have otherwise taken place. The guarantee has also fulfilled the objective of encouraging further commercial lending to Johannesburg. The private banking sector is now undertaking non-securitized lending to GJMC on the basis of its credit rating.

By negotiating a portable guarantee with the city, USAID gave GJMC greater flexibility in "shopping the deal" with big commercial banks. This created additional work for the Mission, as a second round of negotiations had to take place once the lender was selected. However, Mission staff felt justified in following this approach since it allowed GJMC to secure the best deal available at the lowest possible cost to the city.

The Mission also hired local experts to evaluate the pro forma projections provided by GJMC on three sample projects. This allowed the Mission to carefully validate the assumptions that had been built into the financial models.

Bond Guarantee for Municipal Bond Market in the Philippines

Guaranteed Party: LGU Guarantee Corporation

In the mid-1990s, the Government of the Philippines embarked on a credit policy reform designed to phase out all forms of public credit subsidies and directed credit programs. In response to this policy change, a consortium of private Philippine banks set up the Local Government Unit Guarantee Corporation (LGUGC) in 1998 with the help of a government development bank. These banks were intent on developing alternative municipal finance mechanisms to coincide with the decentralization of government functions to Local Government Units (LGUs).

LGUGC provides bond guarantees to private financial institutions willing to invest in public infrastructure projects. These projects must be self-sustaining and generate sufficient revenues to meet operating and debt servicing costs. The goal of the DCA guarantee is to foster the growth of a municipal bond market in the Philippines by showing the long term sustainability of LGUGC's business model and by stimulating further private investments in municipal infrastructure projects.

Intermediary	LGU Guarantee Corporation
Qualified lenders	Private financial institutions
Qualified borrowers	Local Government Units (LGUs)
Qualified loans	Municipal infrastructure projects
Geographic scope	Nationwide
Type of guarantee	Bond Portfolio Guarantee
Max. portfolio amount	$28.5 million (Philippine Peso equivalent)
DCA guarantee	30% of principal & interest
Guarantee ceiling	$8.55 million (Philippine Peso equivalent)
Duration of guarantee	5 years to place bonds under coverage (1999-2004)15 years to submit claims to USAID (1999-2014)
Other covenants	Bond maturities not greater than 10 years DCA interest liabiltiy capped at 15% Claims secured by internal revenue bonds No more than 20% to any one borrower LGUGC's private ownership to increase to 70%
Origination fee	0.5% (payable in Philippine Pesos)
Utilization fee	0.5% per annum (payable in Philippine Pesos)

Term Sheet Summary

1. Project Summary

The DCA Bond Portfolio Guarantee supports USAID/Philippines' Strategic Objective No. 2: Investment Less Constrained by Corruption and Poor Governance.

In the past, the greatest portion of funding for Philippine municipalities, cities, and provinces came in the form of grants from the Government of the Philippines (GOP) or subsidized credit from government-owned banks. However, continuing budget deficits have encouraged the GOP to institute credit policy reform designed to phase out government-subsidized credit and all government-directed programs.

At the same time, the GOP has implemented a decentralization program. Since 1991, LGUs have assumed a growing share of the financial responsibility for their capital improvement. Increasingly, municipal financing must be mobilized from private, domestic lenders through more efficient local credit markets.

The Mission has been particularly interested in leveling the playing field for private banks relative to government-owned banks. Private involvement is expected to make the LGU bond market more business-like, and thus indirectly improve financial management of LGUs.

In 1998, LGUGC was founded by the Bankers' Association of the Philippines, whose members are private banks and a government-owned financial institution, the Development Bank of the Philippines. Its goal is to provide a market-based guarantee fund for bond issues to LGUs, targeted at sustainable, financial-sound infrastructure projects that can repay debt in a timely manner.

- Low-cost housing
- Municipal slaughterhouse
- Port jetty and terminal building
- Hospital renovation
- Public market
- School buildings
- Road network development
- Water supply system
- Convention center

Examples of Municipal Infrastructure Projects

The $28.5 million DCA facility has been essential to establishing the credibility of LGUGC with the local private financial sector, whose investments in the guarantee fund are the most important factor in the fund's long term sustainability.

2. Economic Analysis

Philippine LGUs face many challenges in gaining access to private sources of credit. Most have limited financial capabilities, both in terms of financial resources and planning capacity, and they lack diversified revenue streams. They suffer from low cost recovery of services and inefficient tax administration.

While private banks have expressed interest in lending to LGUs, they lack the necessary experience and credit risk analysis tools. In the absence of a fully functioning LGU credit rating agency, private financial institutions find it difficult to assess the risk profiles of local governments.

Private banks also lack confidence regarding enforcement of LGU repayment obligations, as the courts have sent mixed messages on the contractual obligations tied to municipal loans.

These factors have led to conservative bank lending practices. Without the approval stamp of the DCA guarantee, LGUGC's ability to secure sufficient funding from its members and to engage in meaningful bond guarantees would have remained doubtful. The DCA guarantee has helped stimulate the development of a municipal bond market that was practically non-existent.

3. Local Partners

LGUGC was incorporated in 1998 as a joint venture between a consortium of 21 private banks, which own 51 percent in equal shares, and the Development Bank of the Philippines, a government agency with 49 percent ownership.

As part of the DCA agreement, LGUGC has agreed to increase private ownership from 51 percent to 70 percent over the next four years. It has also agreed to adopt internationally recognized credit rating standards, which will require more open, accountable reporting of financial information.

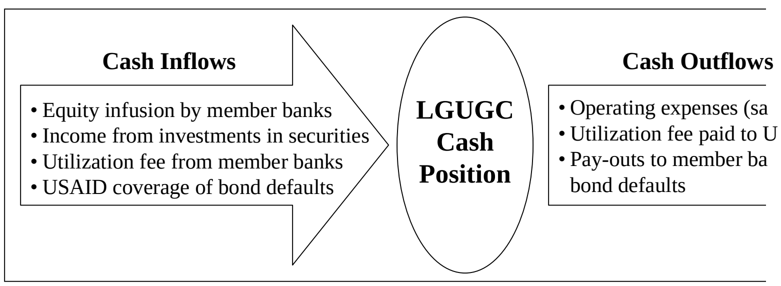
The Regional Urban Development Office (RUDO) in Jakarta was instrumental in working with USAID/ Philippines to find a match between the DCA program and potential recipients. A DCA team from USAID/ Washington and RUDO contractors helped jumpstart the initial analysis and negotiations.

For LGUGC, the main benefit of signing the agreement has been to improve its credibility with the local private financial sector and to secure investment capital from commercial banks.

4. Financial Analysis

Funding for LGUGC comes entirely from equity infusion by member banks and does not involve debt financing at all. After normal start-up expenses, the remaining paid-in capital is invested entirely in highly liquid Philippine treasury securities that produce a guaranteed income.

To validate LGUGC's business plan, 15-year cash flow projections were developed for fund activities as a whole, rather that on the basis of specific projects. The default rate is expected between 2.5 percent to 3.5 percent in the out-years.



Major Components of LGUGC's Cash Flow Projections

Several characteristics of LGUGC's business model have helped moderate risks:

- A lean organizational structure that encourages efficiency and flexibility;
- A sizeable share of projected income coming from stable Philippine securities;
- Ability to control expenses by delaying expansion and hiring if necessary.

LGUGC has attempted to provide bondholders with overlapping layers of protection. Each bond issue is contractually secured by pledges of internal revenue transfers that LGUs receive from the central government. However, the strength of this collateral has been questioned by the Central Bank. Until a test case actually occurs, it is not clear how swiftly the courts and the executive branch of government will act to enforce the guarantees which are in the bond documents.

As an incentive for the development of a long term bond market, government bonds with a term in excess of five years are often provided with a tax exemption. The Mission plans on using policy advocacy to ensure that the tax structure does not distort resource allocations. This may involve extending the tax exemption to other bond categories (such as municipal bonds) or eliminating it altogether.

5. Lessons Learned

LGUGC is off to a strong start, thanks to the stamp of approval provided by USAID. Philippine financial institutions have shown a willingness to invest on the sole basis of LGUGC's financial strength. In several instances, banks have issued bonds backed by LGUGC for financially sound projects that were not eligible for DCA coverage for policy reasons (e.g., a combined hotel/convention center).

LGUGC still faces many challenges:

- It must grow its capital base by increasing private participation.
- It faces competition from government banks which continue to undercut LGUGC with below market loans, in spite of government policy.
- In the absence of an established LGU credit rating agency, LGUGC continues to rely on an independent contractor for its risk analysis.

To improve project oversight, the Mission has pushed for regular management review meetings with borrowers, underwriters, LGUGC, and trustees. This has helped ensure that investment projects are on track, especially funds disbursement by the trustee and interest payments by the LGUs.

Timing of the Mission's participation in the DCA program is another important consideration: obtaining the credit subsidy cost from USAID/Washington early enough in the fiscal year facilitates budget planning activities.

The Mission also recommends using local contractors as much as possible. Local contractors have a good understanding of local market conditions and can typically provide very effective technical and financial expertise at a reasonable cost.

Loan Portfolio Guarantee for Financial Institution in Bulgaria

UBB

Guaranteed Party: United Bulgarian Bank

Bulgaria's public and private sectors are saddled with energy-hungry infrastructure from the Soviet era. Hundreds of millions of dollars of potential energy savings go unrealized every year due to a lack of long-term commercial financing for energy-efficiency projects. Commercial banks in Bulgaria are extremely conservative, and they provide few loans extending beyond 12 months.

USAID has granted a Loan Portfolio Guarantee to the United Bulgarian Bank (UBB) to demonstrate the financial viability of long term project financing for energy efficiency investments. By acting as a catalyst for private financing, the DCA facility is helping reduce unnecessary expenditures on energy, improve municipal finances, and decrease greenhouse gas emissions. USAID is also providing extensive technical assistance to help public and private borrowers identify projects, develop their business plans, and prepare loan applications

Qualified lender	United Bulgarian Bank
Qualified borrowers	Municipalities and enterprises
Qualified projects	Investments designed to improve energy efficiency of infrastructure, facilities and equipment
Geographic scope	Bulgaria
Type of guarantee	Loan Portfolio Guarantee
Max. portfolio amount	$6.25 million (Bulgarian Lev equivalent)
DCA guarantee	50% of principal only
Guarantee ceiling	$3.125 million (Bulgarian Lev equivalent)
Term of guarantee	7 years (1999-2006)
Other covenants	Project cash flows must be sufficient to cover debt service with a 10% margin Loan terms between 3 and 5 years Borrower must contribute 20% of project cost No single loan to exceed 20% of total portfolio
Origination fee	0.5% (payable in U.S. Dollars)
Utilization fee	0.5% per annum (payable in U.S. Dollars)

Term Sheet Summary

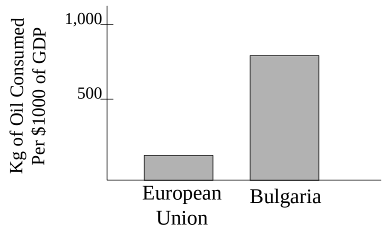
1. Project Overview

Most of Bulgaria's infrastructure, equipment and buildings were built during the Soviet era when energy was significantly under-priced. This infrastructure is now old and deteriorating at a time when Bulgaria must pay market prices for oil.

Today, 70 percent of Bulgaria's energy is imported, and much of it is wasted. Bulgaria uses five times more energy to produce $1,000 of GDP than the European Community (see chart next page).

With the move toward fiscal decentralization and privatization, Bulgarian municipalities are now responsible for maintaining a highly inefficient infrastructure. Energy costs typically account for 7 to 14 percent of municipal budgets. As a result, municipalities have looked for ways to conserve energy. It is not unusual to find pre-school classrooms where the temperature hovers below 60º during winter months.

Bulgaria Is 5 Times Less Energy Efficient Than the EU



Yet, modern energy conservation technology and equipment can have a dramatic impact. USAID funded two successful demonstration projects that helped develop a groundswell of interest in energy efficiency. In one project at a 760 bed hospital, retrofit of a boiler house and improvements to the main building lowered annual energy consumption by 40 percent. These measures also benefited the environment by reducing CO_2 emissions by 33 percent and SO_2 emissions by 29 percent.

The emerging awareness of energy efficiency techniques has created a demand for new investment in cost and pollution reducing technology. Bulgarian municipalities have organized themselves, with USAID assistance, to form the Municipal Energy Efficiency Network (MEEN). They have also linked themselves with international energy efficiency organizations in Central and Eastern Europe.

Changing energy consumption patterns does not come cheaply. As a rough estimate, a 20 percent reduction of energy use in Bulgaria will require approximately $200 million of investments.

2. Economic Analysis

Despite the enthusiasm of local governments and the financial success of several demonstration projects, commercial banks in Bulgaria remain wary of providing longer term credit to municipalities for energy efficiency investments. Most municipal lending is limited to financing short-term needs.

The country's banking crisis of 1996-97 has led to extreme risk aversion among commercial banks, which feel that long-term credit overexposes them. Banks require substantial collateral (up to 150-200 percent of the loan amount) and expect borrowers to co-finance 30-50 percent of total project costs. These restrictive credit policies effectively discourage long-term project financing. Consequently, only 1 percent of commercial bank loans have terms greater than one year.

Another challenge is that lenders and borrowers in Bulgaria have limited experience with project financing. Banks lack the expertise and tools to evaluate credit applications. Municipalities and private enterprises in turn do not know how to prepare the business plans and financial projections that are necessary for banks to perform their analyses.

The $6.25 million Loan Portfolio Guarantee is designed to encourage banks to enter this market by demonstrating the financial viability of energy conservation projects.

Examples of Municipal Energy Efficiency Projects

- Street lighting
- Hospitals
- Schools & child care
- Administrative buildings
- Water & sewerage systems

3. Key Partners

United Bulgarian Bank (UBB) is the second largest bank in Bulgaria with 12 percent of banking system assets. UBB is well-capitalized and profitable with a network of 75 branches. It was acquired by the National Bank of Greece shortly after the DCA agreement was signed.

UBB was already thinking about expanding its municipal loan portfolio when the Mission started promoting the DCA program with Bulgarian financial institutions. The timing was ideal, as the DCA initiative dovetailed UBB's business strategy.

Municipalities are legal entities with the right to borrow funds from commercial sources and issue long-term notes. In principle, all 237 municipalities in Bulgaria are eligible for DCA-backed loans. In practice, only about 35 municipalities are large enough to have the institutional capacity to develop loan proposals.

Given the inexperience of municipalities and private enterprises with project financing, the Mission hired a contractor, Electrotek Concepts, Inc., to provide technical assistance in identifying proposals and turning them into bankable projects. Electrotek is marketing the DCA program in several ways, by:

- Inviting municipalities to attend regional workshops;
- Hosting seminars for industrial enterprises;
- Visiting UBB branches with senior bank officers;
- Publishing articles in local business publications.

Electrotek is helping borrowers obtain financing from UBB by developing business plans, conducting engineering studies, preparing cash flow projections, and drafting loan documentation. Electrotek is also developing risk mitigation strategies to limit downside exposure.

4. Financial Analysis

Two USAID-funded demonstration projects have shown that energy efficiency is a good investment with a short, predictable payback period. A typical project has a pre-financing Internal Rate of Return (IRR) of 25 percent and can repay the debt in three to four years. Such projects require commercial loans with terms of three to five years.

In the first two years, more than 70 projects have been identified, and 10 of these have been successfully financed by UBB. Under the terms of this DCA agreement, banks are encouraged to lend 80 percent of project costs. Here are examples of the financial projections that were developed for UBB loan applications:

Energy Efficiency Project	Initial Cost	Benefits	Payback	Net Present Value	Internal Rate of Return
New heating and lighting system for manufacturer	$110K	Electricity and gas usage: -21%	2.3 years	$177K	47%
Conversion of 20 schools to natural gas heating	$360K	Heating cost: -59%	3.5 years	$188K	30%
Replacement of street lighting system	$144K	Street lighting cost: -74%	2.5 years	$190K	57%
Purchase of two solid waste trucks powered by LPG[1]	$67K	Fuel costs: -76%	2.6 years	N/A	N/A
New heating system and bottling line for brewery	$406K	Heavy oil usage: -35%	2.5 years	$334K	39%

Business Cases For UBB-Financed Projects

[1] LPG: Liquid Propane Gas used as vehicle fuel

The technologies used for these projects are well established and have been implemented successfully throughout the region. The technical risks for projects are therefore quite low. UBB has further protected itself by requiring collateral from its borrowers. For local governments, loans are usually backed by municipal real estate or other types of security.

5. Lessons Learned

The success of this DCA facility has required extensive technical assistance to help municipalities and private enterprises identify projects, develop business plans, prepare loan applications, and structure financing agreements with UBB. Without the help of contractors, the level of activity would have been dramatically reduced.

It has been equally important for USAID's contractors to have a good understanding of UBB's underwriting criteria in order to target projects that have a good chance of being approved. In a small country like Bulgaria, UBB is occasionally privy to non-public information that can adversely affect the bank's willingness to extend a loan to a borrower, particularly in the private sector. To avoid presenting projects that are not acceptable to the bank, the contractor has learned to submit preliminary loan proposals for UBB's vetting before proceeding with full blown business plans.

Lastly, the Mission feels that the success of the Loan Portfolio Guarantee ultimately depends on finding a willing and committed financial partner. It is important that the bank be truly committed to a business strategy that is compatible with the goals of the DCA program. A partner who is simply looking for the stamp of approval of the U.S. Government for prestige reasons will not be as proactive in ensuring the success of the DCA credit facility.

Loan Guarantee for Rural Microfinance Institution in Northern Mexico

Guaranteed Party: Unión Progreso

Unión de Credito Progreso (Unión Progreso) is a rural credit union engaged in small business lending in the northern state of Chihuahua, primarily in the agricultural sector. Its capacity to grow its loan portfolio is constrained by the risk-averse nature of the local banking environment and by a very short term deposit base.

By providing access to outside capital, the DCA agreement has encouraged Unión Progreso to increase its lending activity to microenterprises. It has also given its depositors the confidence to invest in longer term savings products, thereby freeing up additional internal capital. Because the economy in that area is heavily dollarized, the DCA Loan Guarantee covers a dollar-denominated loan from a U.S. bank. To offset the exchange risk, the credit union was required to set aside a reserve of 9 percent of the interest received from loans under the DCA program.

Qualified lender	Unión Progreso
Qualified borrowers	Wells Fargo Bank Texas (based in El Paso)
Qualified projects	Microenterprise and small business investments projected to meet operating and debt service costs
Geographic scope	State of Chihuahua
Type of guarantee	Loan Guarantee
Max. portfolio amount	$1 million (U.S. dollars)
DCA guarantee	50% of principal only
Guarantee ceiling	$0.5 million (U.S. dollars)
Term of guarantee	3 years (2001-2004)
Other covenants	Half or more of loan guarantee to go to microenterprises with balance to small enterprises Micorenterprise loans not toexceed $1,200 Small enterprise loans not to exceed $15,000 Loans not exceed 3 year term
Origination fee	1.0% (payable in U.S. Dollars)
Utilization fee	1.0% per annum (payable in U.S. Dollars)

Term Sheet Summary

1. Project Overview

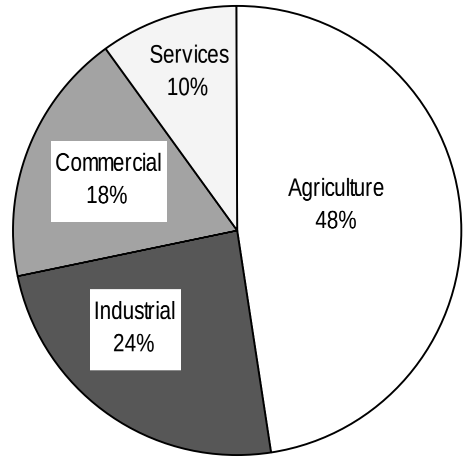
The DCA Loan Guarantee supports the Mission’s Strategic Objective on microenterprise growth, which is designed to strengthen the institutional base for sustainable microenterprise growth by supporting Mexican initiatives. The project peripherally supports the Strategic Objective on environmental preservation and energy conservation.

Unión Progreso is a rural credit union in the northern state of Chihuahua. Most of its microlending is channeled through a Savings Center, where 8,000 microenterprises save and obtain loans. Because of its success, this subsidiary will eventually be regulated under the new savings and credit law in Mexico.

At the time of the DCA agreement, Unión Progreso was USAID's only microfinance partner engaged in both agribusiness and energy conservation projects. As an example, Unión Progreso helped brick- makers transition away from burning tires for fuel in favor of using natural gas, with clear benefits for the environment.

The credit union has sought USAID technical assistance and capital resources to expand its operations in several ways:

Agriculture Dominates Unión Progreso's Loan Portfolio



- *Portfolio diversification* by increasing microlending beyond agribusiness;
- *Geographic expansion* across the state of Chihuahua and nationwide;
- *Greater liquidity* with long term savings products and increased deposits;
- *Image building* as an institution with international recognition.

Access to affordable capital has been Unión Progreso's biggest challenge. The credit union is using the $1 million DCA facility to build credibility with its own depositors and to encourage them to shift their investments from sight deposits to fixed term savings products (up to 360 days). With a more stable capital base, Unión Progreso is able in turn to grow the volume of loans to its target markets.

2. Economic Analysis

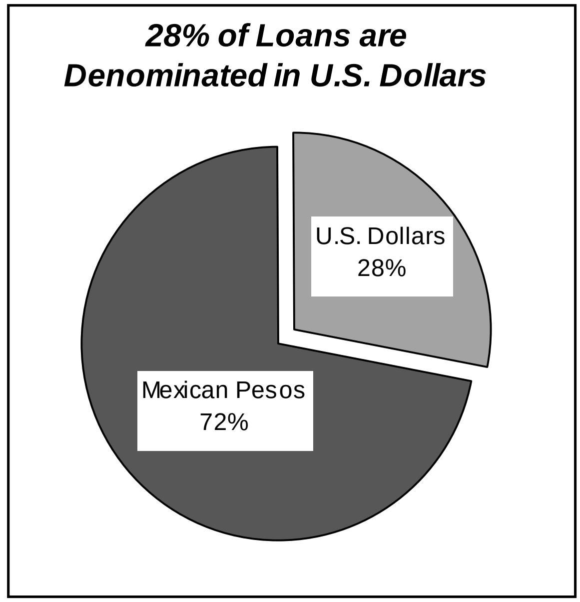
Since the financial crisis of the mid-1990s, Mexico's cash-strapped commercial banks have been reluctant to provide credit to microenterprises and microfinance intermediaries. The banking sector maintains a high level of caution as political and economic reforms continue.

With the shortage of private lending to the microenterprise market, Unión Progreso's ability to raise capital has been severely constrained by prohibitive borrowing costs and high guarantee requirements. And yet, small commercial banks and credit unions like Unión Progreso are the best positioned to meet the growing demand for rural banking and financial services across northern Mexico.

By stimulating increased market-based lending by Unión Progreso, the DCA guarantee is demonstrating the existence of a large, self-sustaining credit market among urban and rural microenterprises and small businesses. In the long term, USAID's participation will also encourage further private sector investments in microfinance institutions, whether from commercial banks or individual depositors.

3. Key Partners

Unión Progreso was established in 1976 by small farmers in Delicias, Chihuahua, to provide credit services for agriculture and livestock businesses. In later years, the group expanded its activities to include seed production, animal feed inventory and sales, farming machine and equipment sales, insurance, accounting services, savings accounts, and real estate.



The state of Chihuahua borders much of western Texas. Consequently the regional economy is highly dollarized, and people hold significant dollar bank accounts. Twenty-eight percent of Unión Progreso's loans are denominated in dollars (see chart).

The terms and conditions of the DCA facility allowed Unión Progreso to negotiate its loan with any U.S. bank. Unión Credito initially negotiated a loan with a small Texas bank, but the size of the loan and the foreign exposure turned out to be too substantial for the bank's board.

Unión Progreso ultimately negotiated its loan with Wells Fargo Bank Texas, based in El Paso. From USAID's perspective, a U.S. bank offered an added benefit: it could be expected to perform considerable due diligence in assessing and monitoring the loan.

Unión Progreso has received technical assistance and training from USAID to create and implement a *Credit Operations Manual*, a training program, a basic credit management system, a credit review process tailored for microloans, a fixed term deposit program and an internal control system. It will also be receiving technical assistance to improve human resources policies and procedures.

4. Financial Analysis

Unlike most other DCA facilities, this Loan Guarantee covers a dollar-denominated loan rather than one based on the local currency. This represents a definite advantage for Unión Progreso as peso loans from Mexican financial institutions are subject to very high interest rates that contained premiums for expected inflation.

The USAID Credit Review Board expressed concerns over foreign exchange risks: the deal introduced a currency mismatch between loan obligations (in U.S. dollars) and revenue sources (1/3 in dollars and 2/3 in pesos). A significant devaluation would put all peso-based lending at risk.

One important factor mitigates this exposure. Unión Progreso's loan repayment ability is supported by the dollar-denominated income generated from its substantial non-financial operations such as animal feed and farming machinery sales, insurance and real estate.

Wells Fargo requested a liquid guarantee equivalent to the loan amount not covered by the DCA guarantee. Unión Progreso accepted this condition because it planned on converting sight deposits by its members into longer-term loanable funds.

The terms and conditions of the DCA facility specify that half or more of the total loan portfolio go to microenterprises, as defined on the next page. The average loan size so far has been $1,700. *(Note: the asset calculation excludes land, buildings, and equipment)*

Type of Business	Share of Loan Portfolio	Max. Loan Size	Defined as... Max. Number of Employees	Max. Asset Value
Microenterprises	50% of more	$1,200	Under 10	$10,000
Small enterprises	50% or less	$15,000	Under 30	$75,000

Terms for Loan Distribution between Microenterprises and Small Enterprises

Unión Progreso has significantly improved its loan portfolio quality since 1997, and past due loans as a percentage of total gross loans have declined from 28 percent to 8 percent. Procedures for recognizing non-recoverable loans were recently introduced at USAID's suggestion.

5. Lessons Learned

Since it involved a dollar-denominated loan with a U.S. bank, this DCA agreement took longer to negotiate. All legal documents had to be translated from English to Spanish and back. After a small U.S. bank backed out of the deal, Unión Progreso had to find a satisfactory partner in Texas who understood the loan market in Mexico. Balancing the need for this extra upfront work, the Loan Guarantee did not require as much extensive monitoring afterwards as a traditional Loan Portfolio Guarantee.

Missions dealing with unsophisticated rural credit unions should be prepared to provide handholding before and after the deal is finalized. The Mission has had to help Unión Progreso interpret and understand the terms of the loan, including reporting requirements and deadlines. Unión Progreso has also required extensive technical assistance to ensure that the operational framework was in place to manage the growing loan portfolio.

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